Pizza Promotion: The Economics of Monopolistic Competition

In Moscow, Idaho, a small college town, many grown-ups would sell their souls for another decent restaurant, if they hadn't already sold them for better air service, an actual shoulder on U.S. Hwy. 95 or a spring that looked less like weak winter. On the other hand, we have an enormous number of fast food establishments per capita, and this provides a good laboratory for studying a market structure called monopolistic competition.

If monopoly anchors one end of the market structure continuum and competition the other, monopolistic competition must lie somewhere in the middle. This seemingly paradoxical market structure borrows easy market entry from competition and price setting behavior from monopoly. In developing the theory of monopolistic competition in the 1930s, Edward Chamberlin wished to inject some realism into the economic theory of markets, having found so few examples of perfect competition and monopoly.

Businesses in monopolistic competition differentiate their products. By creating differences in their products, and promoting these differences, businesses can develop what my marketing colleagues call product or brand loyalty among consumers. With product differentiation comes some pricing power in the marketplace. Unlike a wheat grower, a business with a differentiated product can raise its price and not have its sales go to zero.

Fast food restaurants sell differentiated products. In Moscow, the pizza at Pizza Hut is not exactly the same as that at Domino's, Branegan's, Pizza Perfection, Pizza Pipeline, Papa Murphy's, and Papa John's, but it's still pizza. When I poll my students about the best pizza, I find that they have strong preferences for a specific brand. Owners of these pizza places use valuable resources to promote the different characteristics of their brands, and set prices high enough to cover these promotional costs. My farmer neighbors, by contrast, have no advertising expenditures on their income statements.

But market pricing power doesn’t mean that the road to riches is paved with pizza. How many rich pizza vendors do you know? Suppose owners of pizza businesses were making a killing. Unless pizza barons could keep it a secret, enterprising rivals would soon enter their market, increasing supply, and driving prices down toward cost. The peril of easy entry strikes again.

We have a lot of monopolistic competition in market economies. We can tell by looking at the variety of similar products. Not only pizza, but hair styling, espresso coffee drinks, and auto services, among many others. We can also see that many sellers of these differentiated products make similar ordinary incomes. To make money in this market structure you have to have a NEW product difference and take the money and run before the entrants come and ruin it for you. This is an incentive to innovate, a valuable characteristic of market economies, even if the competition is not perfect.